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Weekly Commentary

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Macro View

By Hubert Marleau

The Inflation Rate Turned in April, but Still Remains High

Submitted May 14, 2022

Since the beginning of the year, financial conditions have tightened significantly. The DXY is up 9.9%, interest rates are up 75 bps, 10-year bond yields are up 135 bps, and BAA credit spreads are up 125 bps, while the S&P 500 is down 850 points. Given that financial conditions are transmitted to the economy through changes in the money supply, it shouldn't be a surprise that the growth of that supply is rapidly slowing down. In the 4 months ended April, the U.S. money supply increased only at an annual rate of 4.5%, compared to 25% in 2020 and 10% in 2021. Moreover, the yearly increase in the world money supply, expressed in USD, is now flat, decelerating to a negative annual rate of 13.5% in the last 3 months. Consequently, prints on real economic activity have either lost momentum or not met consensus, while yearly increases in consumer, producer and import prices have turned downwards as supply-chain snafus are slowly unwinding. The NY Fed's Underlying Inflation Gauge (UIG) - an index that captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data - also looks as if it may have peaked in April.

Acknowledging the certainty that the Fed and other major central banks in the rest of the world will hike their target rates further over the coming months, financial conditions will definitely remain restrictive enough to keep monetary growth at bay. In this connection, the key question is whether this monetary deflation will be just enough to reduce inflation softly, without a recession, or too strong and destroy inflation, while causing a recession. As a rule, 4.0% to 5.0% monetary growth is conducive to a 2-plus-2 economy: that is 2% for inflation and 2% for growth. The Atlanta Fed's NowCasting model is predicting 1.8% growth for Q2 of 2022.

It is possible, however, that we may not get neither a soft landing nor a hard one. There is also a third option. A steepening yield curve and negative real rates during a tightening monetary cycle is a rare phenomenon,

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which could mean a continuation of above par growth with abnormally high inflation. We live in unprecedented times: this idea is worthy of some consideration.

Different outcomes with different probabilities are forcing investors to focus on several scenarios. This situation explains why, so far this year, on 1 out of every 5 trading days the S&P 500 has closed with a gain or loss of 2% or more. Since 1928, the median number of days each year where the S&P 500 gained or lost more than 2% was only 8, out of roughly 250 trading days. We had 16 with such volatilities since the beginning of the year.

At this point, I'm more inclined to think that the brunt of present financial conditions will fall more on inflation than growth. The economy should be able to take the brunt of the Fed. The prospects for better productivity gains are good. Cash positions of the private sector are high; business intentions to invest are favourable; and the level of job openings is elevated.

The skew index, which is a measure of perceived tail-risk in the S&P 500, is down to 120.2 substantially less from where it stood (151.5) at the start of the new year, suggesting that a forthcoming recession is not a sure thing. Meanwhile, through a quantitative lens of the bond market, investors can see traders have significantly and rapidly decreased their inflation expectations over the past 6 weeks, almost getting back towards target. The 1-year break-even yield has fallen from a high of 6.36% on March 24 to 4.6%, to 2.9% in 2 years; and 2.4% in 3 years: well below the top of the Fed's target band, which is 3%.

This week, no other numbers mattered nearly as much as the CPI. The report was consequential. Inflation numbers may have peaked, even though they missed expectations. The annual rate turned down, registering the first decline in 8 months. The headline CPI rose 8.3% year-over-year, while core inflation registered a 6.2% yearly increase: still elevated, but decelerating.

In this connection, I'm still overweight assets that should benefit from a combination of growth and inflation (N-GDP) like energy, industrial, material and real estate stocks because they currently have pricing power. Yet over the next 12 to 18 months, both inflation and recession fears will recede, which should bring about a stock market recovery that could be more or less equal to the amount of value lost since the start of the year.

Thus, we are trimming value stocks in favour of growth stocks. Indeed, investors should not completely neglect proven growth stocks in the technology, biotechnology and consumer discretionary sectors. Crédit Suisse has given us a clear picture of what has happened in the stock market since the start of the year. In a note to Barron's, it reported that S&P 500 value stocks have reported year-over-year earnings and revenue

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growth of 14.0% and 13.7%, respectively, versus 9.3% and 13.1% for growth. “Faster profit and growth from cheaper-value stocks than highly-valued growth stocks is not what investors have gotten used to.” It explains why Nasdaq shed 28%, compared to only 18% for the S&P 500. Indeed, growth stocks have been massacred by the shift in the monetary environment. Macro pressures stemming from a harsher Fed have more than offset the micro benefits of higher earnings. Consequently, they are dirt cheap: cheaper than they were during the 2018 bear market and based on forward PE ratios, near the levels of March 2020. The growth vectors are down, but not out: they have been simply dislocated by huge margin calls. The long-term future has always been better than the short term as it relates to asset prices.

Thus sentiment indicators and flow of funds are showing signs of capitulation, as does the CNN Fear & Greed Index, recording extreme fear at 6 points. The neutral point is 50. The markets are ripe to come back up, but in a volatile manner. The Fed is no longer there to assuage the gyrations. Nevertheless, insiders have been net buyers of stocks since the middle of April.

In this regard, the Fibonacci calculator should be one’s guide. It’s an indicator adapted for a stock market, based on mathematical formulas governed strictly by human emotion. It triggered a buy for the S&P 500 at 3884. Overall, the S&P 500 currently trades for 15 times expected earnings of $266 over the coming 12 months with an equity risk premium of 385 bps. That represents fair value. By year end, we think that the S&P 500 will rally in the second half of the year to end around 4500 and 4800 by next June.

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